

# Gestalt Shift

## From 'Miracle' to 'Cronyism' in the Asian Crisis

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Was the Asia crisis caused by the build up of vulnerabilities in the real economy, with panicky investor pullout as merely the trigger or messenger of a necessary market correction? Or was it caused largely by the normal workings of under-regulated national and international financial markets, the panicky pullout itself being a prime cause? The short answer is, some of both. The article describes the double helix-like interaction of real and financial causes. It then outlines a strategy of escape from crisis, including the reintroduction of capital controls and creation of an Asia Fund.

Explanations are about the only thing not in short supply in the Asian crisis. It would be entertaining to plot them on a matrix, with 'actors' on one axis and 'actions' on the other. Even a small sampling has to include:

- the governments of the crisis-affected countries, individually and collectively (corruption, collusion, nepotism, distorted markets, insufficient democracy, excessive democracy, 'crony capitalism', fixed exchange rate regime, implicit government guarantees to banks and big companies in their foreign borrowing, premature capital-account liberalisation, lack of regional cooperation)
- foreign banks (sloppy credit-risk analysis, excessive confidence in currency pegs, moral hazard behaviour, Panglossian values, panic)
- domestic banks (ditto)
- investors, domestic and foreign (ditto)
- domestic firms (ditto, plus occult accounting, family control)
- the IMF (pressure for premature financial

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<sup>1</sup> This article builds on Robert Wade and Frank Veneroso, 'The Asian crisis: The high debt model vs. the Wall Street-Treasury-IMF complex', *New Left Review*, 228, March-April, 1998, and Robert Wade, 'The Asian debt-and-development crisis of 1997-?: Causes and consequences', *World Development*, August 1998, to which the reader is referred for more references. The article benefits from conversations with Nesli Basgoz, Keith Bezanson, Jagdish Bhagwati, Manfred Bienefeld, Donald Brash, Robert Brenner, Leonardo Burlamaqui, Alessandra Casella, Ha-Joon Chang, Richard Doner, Ronald Dore, Barry Eichengreen, Peter Garber, Stephany Griffith-Jones, Jan Kregel, Stephan Haggard, Barry Herman, Michael Lipton, Arvid Lukauskes, my ad hoc research assistant Robert K. Merton, Percy Mistry, Kevin Muehring, Loren Ross, Eric Wanner, David Weiman, and especially Frank Veneroso.

liberalisation, moral hazard, bail-out conditionality of excessive austerity and excessive emphasis on structural reforms

- the US Treasury (pressure for premature financial liberalisation, insufficient contribution to bail-out funds)
- the Japanese government (insufficient demand stimulus at home, insufficient contribution to bail-out funds abroad)
- the Japanese economy (two-thirds of the Asian economy, in seventh year of stagnation and getting worse)
- 'globalisation', with its free floating responsibility.

This rich diversity reflects, in part, participants' attempts to shift the blame. The main external actors (the IMF and the US Treasury) blame national actors, governments blame outsiders, and national populations blame everyone but themselves. It also reflects the fact that there is not one Asian crisis, but several countries with different kinds of troubles and backgrounds to which different explanations may apply.

Beyond this, the diversity reflects deeper differences in beliefs about rationality and markets. Those whose wider worldview emphasises rationality, self-adjusting markets, and market failure as exceptional, except when governments introduce distortions, see the Asia crisis as the result of rational calculations by rational actors in a situation of market-distorting government interventions. Those whose worldview stresses non-rationality (or a different kind of rationality than that assumed by neo-classical theory), routine failure of well-working markets, and the need for government interventions to modify market outcomes see the crisis as the result of non-rational calculations in under-regulated markets.

The debate about the causes has been less a debate than paradigms ('parrot-times') talking past each other. Some hard testing is needed. The problem is that even in one country several different explanations may contain truth and reinforce each other. But even allowing for country

and time differences, 'There are not eighteen good reasons for anything', as George Stigler once said.<sup>2</sup> This article aims, modestly, not at the necessary hypothesis formulation and testing, but at an interpretative account. It gives prominence to the non-rational elements as an offset to the tendency of economists to be much more accepting of stories based on the assumption of rational calculation, simply because they are more congruent with neoclassical theory. And unlike other accounts, it encompasses both the crisis *and* the prolonged prior success.

## 1 Scale of the Crisis

Table 1 shows the change in exchange rates and stock prices in East and Southeast Asia between June 1997 and late March 1998. The three countries identified as the worst affected – South Korea, Thailand, Indonesia – have had the biggest falls in exchange rates, ranging from 36 per cent to 72 per cent. However, Malaysia and the Philippines, generally regarded as having escaped lightly, have had exchange rate declines of not much less than Thailand and Korea. Adding the fall in the stock market to the fall in the exchange rate to get a broader measure of impact, we have to put Malaysia with the group of worst affected countries, with the Philippines just behind. In short, the conventional understanding that only Korea, Thailand and Indonesia have been badly affected is not true by these measures—Malaysia and the Philippines have been hurt almost as much. Even Japan, Hong Kong and Singapore have taken substantial hits. Taiwan and China look to be least affected.

As of July 1998 it is clear that, except perhaps in the case of Korea, the crisis is not yet in the clearing-up-after-the-storm stage; not a 'V' nor a 'U' but an 'L' or an 'S'. After a respite in early 1998, a second great wave of capital outflow occurred in May and June, and forecasters resumed chasing the economies downhill. A report in the *South China Morning Post* began, 'A cocktail of negative factors is fast unravelling Asian stock markets' first-quarter gains and more losses may be in store as further evidence emerges about the parlous condition of the region's

<sup>2</sup> Quoted in Michael Lipton, 'The East Asian crises, banking, and the poor', paper for East Asian Crisis

Conference, Institute of Development Studies, Sussex University, 13–14 July 1998.

**Table 1: Change in exchange rates and stock prices in Asia (% between 2 June 1997 and 24 March 1998)**

EAST ASIA			
	Exchange rate against US\$	Stock index	Total
Japan	-11	-17	-28
China	0.2	-11	-11
South Korea	-36	-34	-70
Hong Kong	-0.1	-22	-22
Taiwan	-15	10	-5

  

SOUTHEAST ASIA			
	Exchange rate against US\$	Stock index	Total
Thailand	-36	-17	-53
Malaysia	-31	-34	-65
Indonesia	-72	-24	-96
Singapore	-11	-20	-31

economies<sup>3</sup>. It is not an exaggeration to liken the Asian crisis to the Great Depression of the 1930s in terms of the scale of the falls in output and consumption and the increase in poverty and insecurity. Countries have been pushed back down the hierarchy of world income to where they were 10 years ago and more.<sup>4</sup> Meanwhile the international lenders have escaped with small losses, disproving once again the adage, 'If you owe the bank \$1 million you have a problem, if you owe the bank \$1 billion the bank has a problem'.

## 2 The High Debt-Debt Deflation Story

Most commentators agree that the sharp pullout of funds by investors across the region was the trigger, and that the pullout was panicky. The whipsaw movement from capital inflows to capital outflows was on a scale that could not but tear apart the social fabric of countries subjected to it, especially where political structures are only weakly institutionalised. Net private flows to or from the five Asian economies (the ASEAN four plus South Korea) were plus \$93 billion in 1996, turning to minus \$12 billion in

1997. The swing in one year of \$105 billion (with most of the outflow concentrated in the *last quarter* of 1997) equals 11 per cent of the combined GDP of the five countries. Asia's experience was worse even than Latin America's in the 1980s. The swing between 1981 inflows and 1982 outflows in the three biggest debtors (Brazil, Mexico, Argentina) amounted to 8 per cent of their combined GDP.

An interpretative account has to explain why the inflows were so big, why the outflows were so big, and why the contraction of economic activity has continued to be so sharp. It has to link the banking crisis, the currency crisis and the corporate crisis, and the politics with the economics, without becoming so luxuriant as to be obscure.

### 2.1 The bank-based high debt model

Thanks to relatively equal income distribution the large majority of Asian households are net savers (in contrast to Latin America). They deposit much of their savings in banks. Banks have to lend. But not to households and not to governments, which are not sizeable net borrowers. Banks have lent largely to firms seeking to borrow in order to invest.

<sup>3</sup> Jake Lloyd-Smith, 'Asia hunkers down for bumpy journey', *South China Morning Post*, 7 May 1998.

<sup>4</sup> Per capita income measured at current exchange rates.

Large Asian firms have tended to finance a large proportion of their investment from bank borrowings, and to carry a large amount of debt relative to equity, compared to Western or Latin American firms.<sup>5</sup> High debt/equity ratios allowed them to invest much more than through retained earnings or equity finance alone, and high corporate investment helped to propel the region's fast economic development over several decades. Corporate sectors with high levels of debt are vulnerable to shocks that cause a fall in cashflow or an increase in fixed payment obligations—systemic shocks such as a fall in aggregate demand, a rise in interest rates, or devaluation of the currency (when part of the debt is foreign).<sup>6</sup>

This bank-based system of financial intermediation encourages close relations between bankers and corporate managers, and is sometimes called 'relationship' banking. The system often includes government incentives to lend to particular sectors or functions. And it includes, importantly, a closed or partially closed capital account, such that financial capital cannot move freely in and out of the country. Local citizens and foreign residents are not permitted to hold accounts with commercial banks abroad, banks are not allowed to extend loans in foreign currencies in the domestic market, non-bank private corporations are not allowed to borrow abroad, foreigners can not own shares listed by national companies on domestic stock markets, national companies can not sell securities on international stock and bond markets, foreign banks are restricted in the domestic market. This apparatus buffers highly leveraged corporate sectors from

systemic shocks and from the prudential limits of Western banks, allowing them to sustain levels of investment well above what the risk preferences of equity holders would allow. Very high domestic savings permit the investment to be financed domestically.

At its most fully developed the bank-based high debt model becomes the developmental state. The developmental state was most fully developed in Japan (1955–73), Korea (1961–95), and Taiwan (1955–continuing).<sup>7</sup> Amidst the current talk of the death throes of Asian crony capitalism it is worth recalling that Japan, Korea and Taiwan are the most successful non-city-state developing countries since the Second World War. No other countries have achieved such big gains in the average real wage or the average real wage of the bottom 25 per cent. No other countries have risen so far in their technological capacity. Japan takes out more patents in the US than any other country bar the US itself. In recent years, Taiwan has taken out the 6th largest number, Korea the 7th largest, ahead of the middle-ranking OECD countries like Italy, Ireland, Netherlands, Scandinavia.<sup>8</sup> No other developing countries come even close. (But the environmental costs of the model have been very high.) Singapore and Malaysia are closest to developmental states in Southeast Asia, Indonesia is the furthest.

## 2.2 Financial liberalisation

Asian governments, encouraged by the IMF and the World Bank as well as by national business elites, liberalised their financial systems through the

<sup>5</sup> See Wade and Veneroso, *op.cit.*, for discussion of the problems of the empirical evidence on debt/equity ratios. Among other problems, the evidence I have seen includes only long-term debt, and in the case of conglomerates it does not properly consolidate debt so as to account for the practice of one affiliate borrowing to buy quasi-equity in another affiliate, thereby spuriously lowering the second one's debt/equity ratio. Evidence on the size of bank intermediation suggests that the ratio of credit to GDP in Asia in 1990–96 ranged from 207 per cent in Japan down to 114 per cent in Singapore (with Hong Kong, Thailand, Malaysia, and Korea in between, but Indonesia and Philippines around 63–65 per cent). Colombia, Brazil, Mexico, Argentina ranged from 42 per cent to 18 per cent, with Chile at 70 per cent. The US figure was 58 per cent. Source is Goldman Sachs, elaborated in Michael Pomerleano, 'The East Asian crisis and corporate finances: a micro story',

preliminary draft, World Bank, May, 1998.

<sup>6</sup> See 'Shocks and debt', appendix in Wade and Veneroso, *op.cit.*

<sup>7</sup> Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialisation* (Princeton University Press, 1990), chapters 10 and 11.

<sup>8</sup> Parimal Patel and Keith Pavitt, 'Uneven and divergent technological accumulation among advanced countries: evidence and a framework of explanation', *Industrial and Corporate Change*, Vol. 3, 1994, pp.759–87. Robert Wade, 'Globalisation and its limits: reports of the death of the national economy are greatly exaggerated', in Suzanne Berger and Ronald Dore (eds.), *National Diversity and Global Capitalism*, Ithaca: Cornell University Press, 1996.

1990s, including the external capital account.<sup>9</sup> Liberalisation permitted domestic agents to raise finance on foreign markets and gave foreign agents access to the domestic financial market. Hence locals could open foreign bank accounts; banks could extend credit in foreign currencies in the domestic markets; non-bank financial institutions and private corporations could borrow abroad; foreigners could own shares listed by national companies on domestic stock markets; foreign banks could enjoy wider freedom of entry into the domestic banking sector; and off-shore banks could borrow abroad and lend domestically.<sup>10</sup> All this took place in the context of a more or less fixed nominal exchange rate regime, in which the domestic currency was either fixed to the US dollar or moved in close correspondence with it.

The liberalisation of capital movements removed the capacity for governments to coordinate foreign private borrowing. Those who demanded financial liberalisation acknowledged the need for *pari passu* strengthening of bank regulation and supervision, but did not constrain their push for liberalisation by the pace of regulatory strengthening on the ground. In Korea, the Kim Young Sam government of 1993 sharply accelerated the process of financial liberalisation, including, for the first time, substantially opening the capital account. This was done to meet the conditions for joining the OECD, a primary policy goal of the Kim government. It also happened

because the big private firms had by this time high enough credit ratings in international financial markets for them to borrow easily on their own account, and they stopped wanting government support.<sup>11</sup>

As part of the liberalisation, the government licensed nine new merchant banks in 1994 and 15 more in July 1996, in addition to the six that existed before the 1993 liberalisation. These inexperienced merchant banks drove the explosive growth of Korea's foreign debt. The debt rose from \$44 billion in 1993 to \$120 billion in September 1997, most of it private and roughly 65 per cent of it short term.<sup>12</sup> The design of the liberalisation programme itself encouraged short-term foreign borrowing, because the application procedures for *short-term* borrowing entailed much lower transaction costs than those for long-term borrowing.<sup>13</sup> Moreover, the government allowed non-bank firms to borrow abroad on their own account without central coordination. About a third of Korea's total foreign debt is accounted for by these non-bank firms. This borrowing was outside the scope of bank regulation and supervision, yet constituted foreign exchange liabilities for the central bank.

Across Southeast Asia, too, domestic enterprises became free to borrow abroad on their own account with no more public supervision than in Korea. An even higher proportion than in Korea of total foreign borrowing was by non-bank firms: around 60

<sup>9</sup> Japan resisted the push for financial liberalisation in developing countries. Its conflicts with the World Bank and the IMF on this matter in the Asian context gave the impetus to the World Bank's *The East Asian Miracle* study. See Wade, 'Japan, the World Bank, and the art of paradigm maintenance: The East Asian Miracle in political perspective', *New Left Review*, 217, May–June 1996, pp. 3–36.

<sup>10</sup> Azizul Islam, 'The dynamics of Asian economic crisis and selected policy implications', Development Research and Policy Analysis Division, UN ESCAP, July 1998.

<sup>11</sup> Ha Joon Chang, Hong Je Park, and Chu Gue Yoo, 'Interpreting the Korean crisis: financial liberalisation, industrial policy and corporate governance', *Cambridge Journal of Economics*, Vol. 22, No. 6, November 1998.

<sup>12</sup> Bank of International Settlements, 'The maturity, sectoral and nationality distribution of international bank lending', May 1998, Basle. Korea's figure fell from 68 per cent at end 1996 to 63 per cent at end 1997. Indonesia's figures for the same years, 62 per cent and 61 per cent, Thailand's 65 per cent and 66 per cent.

These figures are for lending to the country by foreign banks, where 'to the country' means to any entity in the country, including subsidiaries of foreign firms. The World Bank's figures on total debt and short-term debt in *Global Development Finance* tend to be appreciably different from the BIS figures. The BIS uses creditor statistics (from the loan-extending banks), the World Bank uses debtor statistics (from the debtor governments). The BIS figures cover only bank lending, the Bank also covers non-bank, specifically government or public loans. Yet the Bank's figures are often smaller. The differences reflect first, the poorer quality of debtor statistics (there are many more debtors than creditors, and debtor banks are less well supervised) and second, differences in methodology (on such things as treatment of subsidiaries of banks and non-banks, and the entities whose debts are to be included in external debt – all residents, including subsidiaries of foreign companies, or only nationally-owned debt, including debt of foreign subsidiaries of domestic firms).

<sup>13</sup> Chang, Park, and Yoo, *op.cit.*

per cent in Malaysia and more in Indonesia.<sup>14</sup> All this escaped bank regulation.

In Thailand radical financial liberalisation began in 1988 with the country's first fully civilian government and intensified with the new civilian government of 1992. It included opening to foreign borrowing and the creation of a large number of new finance companies able to compete with the commercial banks.<sup>15</sup> These developments gave politicians plenty of opportunities to raise campaign finance. Political competition undermined any independent monitoring or regulation by the central bank (see below).

In Indonesia, 'the economy's vulnerability to financial collapse can be traced to the mid-1980s, when Indonesia opened the banking industry to competition but never put modern bank regulations in place. "It's as if the Government had gotten rid of the policeman at every corner, but didn't bother to put up stop signs or lights"', suggested [an economist at the University of Indonesia]. "The traffic moved faster, but was prone to accidents."<sup>16</sup>

Liberalising the financial sector and opening the capital account is dangerous when the banks are inexperienced and when non-banks also borrow abroad.<sup>17</sup> It is doubly dangerous in the context of a bank-based financial system and a high debt-to-equity corporate sector. It is triply dangerous when the exchange rate is pegged. When, in addition, the banks and non-banks are essentially unsupervised, a banking-cum-currency crisis is just waiting to happen. In Asia, swift external financial liberalisation with unsupervised banks and fixed exchange rates undermined the previous system of industrial

and banking cooperation and exposed fragile debt structures to unbuffered shocks.

## 2.3 Inflows

The capital inflow side of the story starts with the extraordinary growth of international capital flows in recent years, that now amount to well over 70 times the volume of world trade. The flows are mostly short-term; 80 per cent of net global foreign exchange transactions have a maturity date of seven days or less.<sup>18</sup> The growth of these flows reflects, in part, the efforts of central banks in Europe and Japan to stimulate their economies by means of loose monetary policy.

The growth also reflects the imbalance between savings and investment in Japan. For many years the Japanese, the fastest aging population in the world, have been saving hard for the approaching years of long retirement. (The average Japanese family saves more than 13 per cent of its income, the average American family 4 per cent.<sup>19</sup>) The economy is mature, among the richest in the world, and not able productively to utilise enough investment to absorb the savings. The result is an excess of domestic savings over domestic investment that manifests itself in chronic current account surpluses matched by capital exports.<sup>20</sup>

In the decade 1985 to 1995 the yen appreciated hugely against the US dollar, from about 238 to 80. East and Southeast Asian currencies, linked to the dollar, depreciated against the yen. Real exchange rates moved similarly. At the depreciated exchange rates East and Southeast Asia provided much more competitive production sites. Japanese capital

<sup>14</sup> Bank for International Settlements, 'The Maturity, Sectoral and Nationality Distribution of International Bank Lending, First Half 1997', Basle, January 1998, Table 1, cited in Yilmaz Akyuz, 'The East Asian financial crisis: back to the future?', UNCTAD, processed, n.d. (January 1998).

<sup>15</sup> In March 1993 the Bank of Thailand opened the Bangkok International Banking Facility (BIBF), intending to make Thailand a regional financial hub. In practice it mostly intermediated between Thai borrowers and foreign lenders, all in foreign currency. See Ammar Siamwalla, 'Can a developing democracy manage its macroeconomy? The case of Thailand', paper for East Asian Crisis Conference, Institute of Development Studies, Sussex University, 13–14 July 1998.

<sup>16</sup> Peter Passell, 'Experts say Indonesia can boom, long-term', *The New York Times*, 22 May 1998, p.A10.

<sup>17</sup> Martin Wolf of the *Financial Times* has repeatedly stressed this point. See, for example, 'Caging the bankers', *Financial Times*, 20 January 1998.

<sup>18</sup> John Eatwell, 'International financial liberalisation: the impact on world development', discussion paper, Office of Development Studies, UNDP, n.d. (1997), p.4.

<sup>19</sup> Jacob Schlesinger and David Hamilton, 'The more the Japanese save for a rainy day, the gloomier it gets', *Wall Street Journal*, July 21, 1998, p.A1.

<sup>20</sup> Martin Wolf, 'Saving Japan: a permanent cure', *Financial Times*, April 7, 1998.

flooded out to Asia, much of it in export-oriented production aimed at the US. Capital from other core economies joined in. With such high rates of investment, much of it in tradeables, the economies grew at speeds rarely equalled in human history. Thailand had about the highest growth rate in the world in 1985–94.

Japan's imbalance between saving and investment grew after the early 1990s because of the bursting of the property, stock market and currency bubbles. Japanese banks found themselves with many bad loans. Banks near to insolvency tend to take big risks unless they are recapitalised, merged, or forced into bankruptcy. Rather than follow one or other of these solutions the Japanese government decided to allow them to write off the bad loans gradually (to 'trade through'), giving them extra profits via a low bank rate and tax-avoiding declarations of losses.<sup>21</sup> Meanwhile the voracious Japanese appetite for savings continued, the savings going mostly into the banks. The banks had to lend. The 'near to insolvency → high risks' pressure therefore continued.

Japanese banks aggressively sought high returns from foreign lending, much of it in risky loans to Southeast Asia. They found themselves able to borrow both domestically and abroad at low rates. They lent short term to Southeast Asian banks and firms at appreciably higher rates, confident that Southeast Asian currencies would remain pegged to the US dollar. They thereby earned both an

interest gain and (as the yen depreciated against the US dollar after 1995) a currency gain. European banks also lent heavily, especially after the flight from Mexico in the wake of the Mexican crisis of 1994/95. By mid-1997 European banks accounted for the largest share of the region's external bank debt, with 39 per cent. Next came Japanese banks, with 33 per cent.<sup>22</sup>

On the demand side, banks and firms in Korea and Southeast Asia rushed to borrow abroad. Borrowing abroad at roughly half the cost of borrowing domestically seemed to be a one-way bet. You could only win. The proviso was that the currency peg to the US dollar be maintained, precluding exchange rate risk. (The higher credit-rated banks and enterprises of Korea not only borrowed abroad and lent domestically, they also on-lent to Southeast Asia.)

At the same time, capital flowed in to accommodate the excess of investment over savings. Gross domestic investment was even higher than gross domestic savings, itself about the highest in the world at well over one-third of GDP. In short, the inflows were driven both by the need to accommodate the excess of investment over savings (manifested in current account deficits, see below), and by the opportunity, thanks to capital account opening, for foreign creditors to get higher returns and domestic borrowers to borrow more cheaply. They were also driven by the image of 'miracle Asia'. Nobody was paying much attention to the growing imbalances in the banking systems or to other risk

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<sup>21</sup> The opprobrium now directed at the Japanese government for not moving earlier to clean up the banking system conceals the point that, as of 1996, before the wider crisis, the trading-through strategy seemed to be working tolerably well compared to the likely alternatives. And it ignores the point that the US government waited from 1984 to 1988 before it developed a comprehensive wind-up rescue plan with public money to clean up the Savings and Loan crisis. The US's disregard of the wider impacts of its macroeconomic policy choices (as in the Volker interest rate hike, undertaken with no thought to its impact on Latin America, and its reluctance to contribute to the Bretton Woods institutions and the UN) does not qualify it to be self-righteous about Japan's choices. On alternative methods of debt workouts see Wade and Veneroso, op. cit.

<sup>22</sup> 'Asia and Europe: Hard talking', *The Economist*, 4 April 1998, p.42. The Asian countries in the calculation include South Korea, China, Indonesia,

Thailand, Taiwan, Malaysia, Philippines. US banks accounted for only 8 per cent of external bank debt as of end-June 1997. However, derivatives complicate the picture. American banks hold a large amount of derivatives contracts with Asian entities, probably more than other banks. For example, J.P. Morgan, which, of the American banks, probably has the most at stake, had \$116 billion total credit risk from derivatives at the end of 1997. A loss of one-tenth of that amount would wipe out its equity. In 1997, 90 per cent of its non-performing loans were defaults from Asian derivatives counterparties. Derivatives are more likely to be defaulted on than loans, because the counterparty 'can always say [it] didn't understand the derivative or the bank tricked [it] or whatever', and hence 'Companies do not view a default on derivatives as face losing' (financial analyst with Standard and Poor's). Bernard Baumohl, 'Asia crisis: The banks' nuclear secrets', *Time*, 25 May 1998, pp.46–47, 50.

factors.<sup>23</sup> The inflows put *upward* pressure on the exchange rate. The attention of the monetary authorities and of speculators and investors was on the chances of preventing appreciation of the nominal exchange rate. Nobody was thinking depreciation. Nobody was hedging against a currency sell off.

## 2.4 Real vulnerabilities

The proximate source of real economy vulnerability was the deterioration in the current account in all the affected countries, especially in 1995 and 1996. The deficits for 1996 ranged from 3.5 per cent of GDP for Indonesia to 8 per cent for Thailand. The most rapid increase occurred in Korea, which went from one per cent in 1993–95 to 5 per cent in 1996.

Falling export growth was the main cause of the rising deficits. This reflected, first, a fall in demand for some of the main exports, notably semiconductors in the case of Korea (semiconductors being Korea's biggest single export item). Falling export growth reflected, second, declining competitiveness as a result of domestic costs rising faster than productivity. Capital inflows combined with the currency peg caused appreciation of the domestic currency. The real exchange rate appreciated in all five of the most affected countries in 1995–96, choking exports.<sup>24</sup>

Third, the nominal exchange rate rose sharply against the yen from spring 1995 onwards, as the yen fell against the dollar (from a peak of 80 in

1995 to 147 in June 1998). Investments that had been competitive at the earlier exchange rate were now less competitive, especially against Japan and China. Much investment now looked to be 'excessive'. Fourth, the terms of trade (export prices over import prices) were trending downwards, due especially to competition from China. Fifth, China gobbled up export markets in the US and Japan over the 1990s, raising its overall share of US merchandise imports from 3 per cent in 1990 to 6 per cent in 1994 and its share of Japanese merchandise imports from 5 per cent to 10 per cent. Its share of US footwear imports rose from 16 per cent to 45 per cent in the same years, its share of Japanese clothing imports rose from 28 per cent to 54 per cent.<sup>25</sup>

As investment surged throughout the region, much of it into a narrow range of sectors, productivity and profits began to suffer. At the margin, companies put more and more investment into non-tradeable speculative ventures, including property and land. Thailand, Malaysia, and Indonesia all experienced speculative property balloons inflated by foreign finance. The borrowers received returns in local currency and had to repay in foreign currency. They began to accumulate a massive currency mismatch.

In terms of their structural position in the world economy the Southeast Asian economies have been much more dependent on foreign expertise and foreign capital than were the East Asian economies at the same average income level. The prospects of their following the East Asian trajectory were always much more uncertain. They have remained in a

<sup>23</sup> It will be interesting to read future histories of the World Bank, the IMF and the rating agencies to see how contrary information was kept out of their reports, and what happened subsequently to the responsible managers. See Marcus Brauchli, 'Speak no evil: why the World Bank failed to anticipate Indonesia's deep crisis', *Wall Street Journal*, 14 July 1998. (Thanks to Laura Resnikoff for drawing it to my attention.) As an example of the problem, the staff of the World Bank's resident mission in Indonesia prepared a speech for President Wolfensohn to deliver during his visit in the autumn of 1997, praising Indonesia's performance but also containing a strong warning of serious difficulties that needed urgent attention. Wolfensohn himself deleted the passage, substituting an even more fulsome endorsement of Indonesia as an Asian miracle. As another example, the Bank's lead economist for Thailand in 1994 wrote the (confidential) annual report on the

economy and the Bank's strategy (the Country Assistance Strategy), and warned of major problems associated with the build up of foreign debt. His division chief removed most of the bad news. The division chief was promoted, the lead economist left the division. Neither Wolfensohn nor the division chief had independent empirical grounds for reversing the judgment of their subordinates. 'We were caught up in the enthusiasm of Indonesia', said Wolfensohn to critics in Jakarta in early 1998 – with disingenuousness in the 'we'.

<sup>24</sup> Raphael Kaplinsky, "If you want to get somewhere else, you must run at least twice as fast as that!": The roots of the East Asian crisis', paper for East Asian conference, Institute of Development Studies, Sussex University, 13–14 July 1998 (edited version in this volume).

<sup>25</sup> Kaplinsky, *ibid*.



subcontractor role. They have seriously underinvested in education, resulting in secondary school enrollments in Thailand and Indonesia half or less than half those of Korea and Taiwan at the same per capita income level. They suffer serious infrastructure congestion. These endowment problems, combined with Chinese competition from below and Korean, Taiwanese, Japanese and European competition from above, have pinned them in a medium technology trap.

The advent of democratically elected civilian governments in Thailand and Korea added to their vulnerabilities. In Thailand this began in the late 1980s with the first democratically elected government, and intensified under the next civilian government of 1992.<sup>26</sup> These governments began to undermine the previously high level of autonomy and competence of the economic technocracy. Their constituency lay predominantly in rural areas well away from Bangkok. Candidates who purchased votes to win parliamentary elections ran up huge obligations. The successful candidates, eyes on their war-chests, set about capturing income and power in the state bureaucracy. The first civilian government was popularly known as 'the buffet cabinet' in tribute to its appetite for money. 'To them, and more importantly, to their constituents, the public treasury is a milchcow, and the MPs' central chore is to milk that cow and bring the milk back home to their constituents'.<sup>27</sup> The finance ministry and the central bank, whose independence and technocratic excellence had helped previous military governments maintain macroeconomic stability, came under their sway. Political appointees went into senior positions and corrupted decisions about economic policy.

In Korea, the first democratically elected civilian government, under President Kim Young Sam, came to power in 1993 committed to far-reaching liberalisation. It abolished the investment

coordination superministry (the Economic Planning Board), folding it into the Ministry of Finance. At the same time it allowed some of the *chaebol* to become closer to, more personalistically involved with the regime than had its military predecessors since the beginning of the 1960s.

Problems were also building up in Korea's corporate sector. A series of bankruptcies occurred in 1997, which contributed to the November 1997 crash.<sup>28</sup> The bankruptcies were concentrated in the middle-ranking, rather than among the biggest, *chaebol*. The middle-ranking ones had, over the 1990s, borrowed the most, relative to their equity, in order to grow and diversify as fast as possible, seeking to catch up with the leaders. They were able to borrow so much because company accounting practices allowed them to cross-guarantee the debts of one affiliate with promises from other affiliates, instead of presenting stand-alone business investment projects independently collateralised. The practice of cross-guarantees between the affiliates of a *chaebol* exposed the whole conglomerate to the default of one of the components. The middle-ranking *chaebol* were also allowed to borrow so much because they bribed the relevant bankers and politicians, and because international banks based in Japan, Europe and the US practically begged them to take the money.

The bankruptcies in Korea revealed serious shortcomings in several institutions, including irregular supervision of the banks, feeble supervision of company accounting practices, and growing dishonesty among public officials. Above all, they illustrated how the *chaebol* dominate the economy, marginalising small and medium enterprises and robbing Korea of an equivalent to Taiwan's swarms of small, nimble, niche-seeking firms. Indeed, some of the IMF's conditions on such matters as corporate governance – matters that seemed a long way from the solutions to the immediate crisis – were inserted

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<sup>26</sup> The first government was headed by Chatchai Choonawan and lasted from 1988 to 1991. After a military interlude the second civilian government was headed by Chuan Leekpai from 1992 to 1995.

<sup>27</sup> Ammar Siamwalla, 'Can a developing democracy manage its macroeconomy? The case of Thailand', op.cit. See also Richard Doner and Ansil Ramsay, 'Thailand: from economic miracle to economic crisis', unpublished paper, Political Science Department, Emory

University, January 1998. Donald Emmerson, 'Economic rupture as political rorschach: paradigmatic aspects of the East Asian crisis', unpublished, Political Science Department, University of Wisconsin, Madison, March 1998.

<sup>28</sup> John Mathews, 'Fashioning a new Korean model out of the crisis', *Cambridge Journal of Economics* Vol. 22, No. 6, November 1998.

with the encouragement of Korean Ministry of Finance officials, who saw the crisis as a golden opportunity to force through structural changes which they had long wanted, but which had been blocked in the Korean political process.<sup>29</sup>

Over and above the condition of each country was the fact that they were fairly highly integrated (roughly half of total trade was intraregional) *and* moving cyclically rather than countercyclically. Had they been less integrated or less synchronised, the regional multiplier effects would have been much smaller. (Taiwan has survived relatively unscathed partly because its boom and bust had taken place in the early 1990s. By the time this crisis hit the region Taiwan's banks were in relatively good shape.<sup>30</sup>) The third vital element in the regional picture, after integration and cyclicity, was the stagnation of Japan, that accounts for two-thirds of the East and Southeast Asian economy.

In short, the vulnerability of the real economy in Asia did increase in the few years before the crisis. Price and investment trends led to growing current account deficits. Also, at least in Thailand and Korea, new civilian democratic regimes corrupted the central policymaking technocracy and lost focus on *national* economic policies. Government–bank–firm collaboration came to be steered more by the narrow and short-term interests of shifting coalitions. Their experience is bad news for the proposition that more competitive politics yield better policies.

## 2.5 Outflows

Granted that the whipsaw movement of capital inflows and outflows is the main proximate cause of the crisis, could it have happened without serious vulnerabilities in the real economy? Almost certainly, yes. We know from history that financial crises can occur in the absence of *ex ante* signs of rising vulnerability (though any self-respecting analyst can find vulnerabilities *ex post*). Indeed, when

times are good and demand is fast growing, firms tend to assign increased weight to past positive experience and reduce the probability of loss associated with some of their investment projects. They may cut back their cushion of safety (probable cash-flow minus probable fixed payments) and thereby become *more* vulnerable to a downturn.<sup>31</sup> This is how, paradoxically, the passage from a sound, to a fragile, to an unstable financial system can occur even faster after a period of good times than after a period of uncertain times.

Also, we know that bankers and money managers tend to exhibit herd-like behaviour based on the incentive that any individual banker or individual bank will be faulted by management or shareholders for missing out on business that others are getting, but will not be faulted for making losses when everyone else is making losses. The effect is compounded by information cascade, such that the entry (exit) of one prominent actor is interpreted by other actors to signal that the situation is better (worse) than they thought. They then enter or exit for reasons related not to their own independent assessment of risk and reward, but to their presumption that the first actor knows something they do not.<sup>32</sup>

The fall in export growth and rising current account deficits by 1995/1996 made for mild concern among international banks and money managers, especially regarding Thailand. But doubts were held at bay by the continuing fast growth and the image of miracle Asia. Then the outlook for speculators and investors in the European and US markets improved in 1997. Interest rates looked set to rise, presenting lenders with opportunities for higher risk-adjusted returns than they had had before. Equity markets soared.<sup>33</sup> In Japan, on the other hand, the outlook turned for the worse in the second quarter of 1997. In early May 1997, Japanese officials, concerned about the decline of the yen, hinted that they might raise interest rates. The

<sup>29</sup> Mathews, *op.cit.*, based on interviews with Korean officials in January 1998.

<sup>30</sup> Wade and Veneroso, *op.cit.*, p.11.

<sup>31</sup> Jan Kregel, 'Yes, "it" did happen again – a Minsky crisis happened in Asia', March 1998, unpublished, Jerome Levy Institute, New York.

<sup>32</sup> Suchil Bikhchandani, David Hirschleifer and Ivo Welch, 'Learning from the behavior of others: conformity, fads, and informational cascades', *Journal of Economic Perspectives*, Vol. 12, No. 3, 1998, 151–70.

<sup>33</sup> Chris Rude, 'The 1997–98 East Asian financial crisis: a New York market-informed view', Department of Economic and Social Affairs, UN, July 1998.

threat never materialised. But the combination of the threat of a rise in Japanese interest rates in order to defend the yen, plus the worries that were circulating about Thailand's currency, plus the brighter opportunities in the US and Europe, raised fears among commercial bankers, investment bankers, and others about the safety of big investment positions throughout the region that were predicated on currency stability.

The Asia crisis proper began as a huge liquidity crisis in Thailand. First, the Thai property and stock market bubbles burst in 1995 and 1996, respectively. The property market is a market where small withdrawals can have a big effect on prices and leave the banking system in the sort of danger that makes depositors withdraw their money. The property market crash ripped through the whole financial sector and on into the foreign exchange market as foreign investors saw that a devaluation would render domestic borrowers less able to meet the now more expensive debt service charges on their short-term foreign loans. With a baht devaluation in sight (a breaking of the peg), companies in Thailand, both foreign and domestic, tried to sell their baht for dollars. Foreign banks realised they had large short-term foreign exchange loans to Thai borrowers that were unhedged and perhaps uncovered by Thai reserves. Knowing that the profitability of their loans depended on the currency peg, they raced for the exits at the first signs that the peg might not hold. There were runs on the baht in mid-1996 and again in early 1997. The Thai Central Bank bought baht to prevent the price fall, but eventually gave up as reserves fell to dangerously low levels. It also resorted secretly to borrowing abroad and including the borrowed funds in its officially declared reserves.<sup>34</sup>

With reserves running out, the baht was floated in early July 1997, and sank. The IMF entered Thailand in August 1997 with a support package and conditionality measures that included the freezing of many finance companies. This was the start of what Jeffrey Sachs has called the IMF's screaming fire in the theatre.<sup>35</sup> The freezing of finance

companies sent uninsured depositors into a panic. Later the IMF imposed the closure of some domestic banks in Indonesia with the same result (inevitable where deposits are uninsured).

Taiwan's small (12 per cent) devaluation in October, despite its towering foreign exchange reserves, acted as a firebridge from Southeast to East Asia. After Taiwan's unexpected devaluation the Hong Kong dollar and the Korean won suddenly looked set for a catch-up devaluation. As holders of these currencies, too, tried to pull out the crisis grew from a 'Southeast Asian' crisis to an 'Asian crisis'. In October to December Japanese, US and European bankers demanded full repayment of interest and principal from their Korean borrowers as short-term loans came due, and the Korean government had no option but to turn to the IMF. The IMF and the Korean government signed a \$57 billion rescue package in early December. In mid-December the Koreans revealed that their short-term debt was nearly double what they had claimed only the week before, in other words, \$95 billion. The gap between \$95 billion and \$57 billion left scarcely a dry pair of pants in the official community on either side of the Pacific.

A very big rescue package at this point could have stopped the crisis from spreading. Better information about bank and corporate balance sheets might also have checked the panic by enabling investors to discriminate between good and bad assets. Instead, the perception shifted from 'miracle Asia' to 'Asian crony state capitalism' almost overnight. 'Crony capitalism', originally coined by activists in the anti-Marcos struggle in the Philippines, was now appropriated to convey a told-you-so moral about the dangers of government intervention.<sup>36</sup>

## 2.6 Debt deflation and import inflation

Once floated, the currencies fell in vicious iteration with domestic bankruptcies (which no amount of developmental state socialising of risk could avoid). As foreign banks that had been routinely rolling over their short-term loans began to demand repayment of not only the interest but also the whole of the principal, highly leveraged firms found their

<sup>34</sup> For more on the chronology of the crisis, see Wade, 'The Asian debt-and-development crisis of 1997-?', op.cit.

<sup>35</sup> Jeffrey Sachs, 'The IMF and the Asian flu', *The*

*American Prospect*, March–April, 1998, pp.16–21.

<sup>36</sup> Donald Emmerson, personal communication, 2 May 1998.

cashflow insufficient to cover their now much higher payment obligations. They started to reduce their cash outflows by delaying payments to suppliers, cutting back on expenditures, raising cash by selling inventories at cut-rate prices, selling assets at whatever they could fetch, and firing employees. In Korea and Southeast Asia the proportion of technically insolvent large companies (unable to pay interest charges out of net cashflow) was expected to jump between 1997 and 1998 from 21 per cent to 32 per cent in Korea; from 11 per cent to 19 per cent in Malaysia; 16 per cent to 46 per cent in Indonesia; 11 per cent to 18 per cent in the Philippines.<sup>37</sup> The calculations date from February 1998. More recent ones would show higher figures for 1998. The tragedy is that many of these insolvent companies were well managed and profitable in competitive markets. The process fed through from firms to banks as banks wrote off loans and wrote down assets. Their calling in of loans put pressure on their borrowers, and those that go bankrupt put pressure on their depositors. The financial economy and the real economy dragged each other down.

This is 'debt deflation', akin to the Great Depression of the 1930s.<sup>38</sup> Debt deflation is a downward pressure on prices of both products and of assets at a time when investment demand is falling, resulting in a *rising* real value of debt. It is given a vicious twist in Asia by the steep rise in the price of imports, including intermediate goods and medicines. Asia is now caught in the slow, painful unfolding of debt deflation with import inflation. It is all the worse because of Asia's high debt/equity ratios, that impart a bigger multiplier effect to a given reduction in demand and cashflow. This is

how, in the chaos theory metaphor, the butterfly that flapped its wings in Thailand caused a hurricane across Asia.

## 2.7 The IMF's role

The IMF's interventions in Thailand, Indonesia and Korea (and informally, without funding, in Malaysia) have made things worse than need be, according to this story. Misdiagnosing the problem as a macroeconomic balance-of-payments problem (the type of problem it is used to dealing with) rather than as a microeconomic debt deflation problem, and as a crisis of excess consumption rather than excess investment, the IMF insisted on a domestic austerity package and on fundamental structural reforms in return for bail-out funds.<sup>39</sup> It justified big increases in real interest rates on the grounds that high rates would be an incentive for domestic capital to stay at home and foreign lenders to resume lending, which would boost the currency. The currency boost would both make it easier for domestic firms to repay their foreign debts and check the dangers of competitive, 1930s-style devaluations. It insisted upon far-reaching structural reforms, because, as First Deputy Managing Director of the IMF Stanley Fischer says, 'The faster [the underlying structural problems in the financial and corporate sectors are dealt with], the shorter the period of pain, and the sooner the return to growth'.<sup>40</sup>

This was the theory. In practice the increase in real interest rates combined with other elements of the austerity package (tax increases, cuts in government expenditure) only depressed firms' cashflow and raised their fixed payment obligations, tipping

<sup>37</sup> A comparable calculation for Thailand, for 1996 and third quarter 1997, gives a jump from 12 per cent to 36 per cent. The figures are to be taken as no more than rough approximations. They are based on Goldman Sachs, *Asset Quality for Korean Banks, Part II, Bottom-Up Approach for Estimating NPLs*, 19 February 1998, William Mako, *Thai Corporates: Origins of Financial Distress and Measures to Promote Voluntary Restructuring*, as elaborated by Michael Pomerleano, 'The East Asia crisis and corporate finances: a micro story', preliminary draft, World Bank, May 1998.

<sup>38</sup> Jan Kregel, op.cit., Wade and Veneroso, op.cit., Wade 1998, op.cit.

<sup>39</sup> The Fund's conditions in Asia are open to the same

critique as Mark Blaug makes of economists' advice about the transition problem in Eastern Europe: 'We have not been very good at thinking about the transition problem in Eastern Europe because we have not been thinking about how market economies actually work and what is required to make markets function. So our advice to Eastern Europe has been very wooden...'. Mark Blaug, 'The state of modern economics: the problems with formalism', interview, *Challenge*, May-June 1998, pp.35-45, at p.43.

<sup>40</sup> Stanley Fischer, 'Year of upheaval: the IMF was right on high interest rates and immediate restructuring', *Asiaweek*, 17 July 1998. Compare in the same issue, Joseph Stiglitz, 'Road to recovery: restoring growth in the region could be a long and difficult process'.

more and more into insolvency, accelerating the outflows and reducing the inflows. In prioritising the return of capital flows the Fund forgot that private capital flows are cyclical rather than counter-cyclical. When a whole economy is sinking and instability abounds foreign capital will not return, whatever the interest rate. Certainly the high real interest rates did not have the effect of reversing the currency falls in Asia. And the cross-country evidence shows no clear relationship between the level of real interest rates and changes in the exchange rate.<sup>41</sup>

A sharp dose of austerity may make sense for a Latin American-style excessive consumption crisis. But the Asian crisis was related to excessive investment (much of it in non-tradeables), not excessive consumption. IMF demand compression worsens already existing problems of excessive capacity. Similarly, being required to undertake fundamental structural reforms at the height of the crisis worsened confidence, reinforcing the 'cronyism-failure' gestalt. Requiring a sharp rise in bank-capital-adequacy standards in the midst of the crisis caused a cut in credit, a rise in non-performing loans, and further bankruptcies. The Asian experience confirms that the middle of a liquidity crisis is a bad time to make radical financial reforms.

The Fund also required the governments to guarantee the foreign debts of local firms and banks. Protected from default, foreign creditors hung back on rescheduling or rolling over the debt. This worsened the hard currency squeeze on local debtors, pushing them to buy foreign exchange to cover their increased dollar needs and adding to the exchange rate collapse.

These various policy mistakes help to explain why the crisis has been so protracted. Their effects are compounded by the high debt/equity ratios of the corporate and financial systems, by the relatively high level of regional integration, the synchronous

movement of all the regional economies except Taiwan, and by Japan's stagnation. Mexico in 1994 recovered relatively quickly by exporting to the giant to the north, whose political structure was sufficiently institutionalised to accommodate a \$20 billion swing in trade balances in one year. Had Japan been expanding it might have played a similar role as the US to Mexico. Fears of further falls in the Japanese yen (even after the steep fall of June 1998 to 147 yen to the US dollar) add to the continuing reluctance to invest and raise fears of competitive devaluations, notably in China and Hong Kong.

### 3 The Future

As of July 1998 governments of the region are beginning to follow an expansionary policy, lowering real interest rates, expanding the monetary base, and running bigger fiscal deficits. This represents a considerable change of direction.<sup>42</sup> It sets aside the central bank orthodoxy that has dominated the discussion, according to which very low inflation, restrained demand, and high real interest rates are the top priorities. Governments now have to channel credit into export industries, generate an export boom taking advantage of exchange rates, and let the profits therefrom reinforce inflationary expectations in reflation domestic demand. Hopefully inventory depletion will be followed by a bounce-back in demand.

Governments may have to reintroduce some form of cross-border capital controls for this strategy to be viable. Indeed, it is not obvious why Asia needs to draw capital from the rest of the world (except in the form of FDI, a small proportion of the total). Its savings are more than enough to support the volume of investment that is productive and profitable without being speculative. Of course, the reintroduction of some forms of capital controls in Asia would be a major setback in the current Big Push for liberalisation of capital movements worldwide, and would be fiercely resisted by Western financial

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<sup>41</sup> See Joseph Stiglitz, 'Knowledge for development: economic science, economic policy, and economic advice', Annual Bank Conference on Development Economics, World Bank, Washington D.C., April 1998.

<sup>42</sup> The Fund has endorsed some relaxation. It is not clear how much the Fund had a change of mind and how much it is making the best of fait accompli. See Wade,

'Asian water torture', *Financial Times*, 23 June 1998, Wanda Tseng (Acting Director, Asia and Pacific Department, IMF), 'Near-zero interest rates are no panacea for Asia', letters, *Financial Times*, 6 July 1998, Wade, 'IMF and US Treasury playing catch up on Asia strategy', letters, *Financial Times*, 14 July 1998.

interests.<sup>43</sup> If capital controls are not reestablished the exchange rate must float. The Asia crisis shows only too clearly the dangers of free capital movements and fixed rates.

The escape from crisis could be much accelerated through regional cooperation between the governments and their central banks. The lack of deliberately concerted regional expansion is one of the most striking features of the whole story. The region has the means to solve the crisis if only it could put them to work: some \$700 billion of foreign exchange reserves between China, Hong Kong, Taiwan and Japan, growing current account surpluses in the crisis-affected countries (even if due more to import compression than export expansion), net creditor positions in terms of foreign asset ownership, and huge savings. The magnitude of the neighbourhood contagion effect gives each country an incentive not to free-ride.

These endowments could easily provide the basis for an Asia Fund. The Fund would help member countries replenish reserves as soon as signs of distress become obvious, thereby reducing the chance of investor pullout. It would be designed to be quick disbursing and lightly conditional. Even the first moves towards an Asia Fund might trigger a shift of image from 'failure' to 'recovery' and send Western capital racing to take positions before prices rise – especially if Western stock markets fall from current valuations that are, in the US case, twice the previous historic highs.<sup>44</sup>

The main obstacle is political. Japan's proposal for an Asia Fund, made in mid-1997, was shot down by the US Treasury, which wanted any such thing to be within the IMF. Japan has since exercised negligible leadership, and remains paralysed by the power struggle between big manufacturing wanting a weak yen, and banks wanting a strong yen. China has shown a moderate amount of leadership, and emerges from the crisis with its reputation enhanced relative to Japan's. But it is the US Treasury under Secretary Rubin and Under Secretary Summers that has been shaping the overall strategy, both directly and indirectly via the IMF.<sup>45</sup> The US emerges from the crisis with much greater power in the region than it had before. And the US does not want an Asian initiative that would exclude it from a central role.<sup>46</sup> Nor does China want a Japanese-led fund.

Until Asian governments – very much including the Japanese government – adopt expansionary policies, take control of short-term capital movements, and cooperate within the region, the crisis is likely to drag on and on, like water torture, bringing poverty and insecurity to hundreds of millions of people and turning parts of Asia into a dependency of the IMF and its number one shareholder.

## 4 Conclusion

'Real' or 'financial' causes? Rational behaviour, boundedly rational, or non-rational? Individually rational, collectively non-rational, socially suboptimal? Specific and exceptional market failure or

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<sup>43</sup> See Wade and Veneroso, *op.cit.*, Wade, 'The Asian debt-and-development crisis of 1997–?', *op.cit.* Chris Rude, 'The 1997–98 East Asian financial crisis', *op.cit.*, emphasises the ambiguity in the minds of Wall Street money managers about what to do. Wearing their 'market professional' hat they are sympathetic to the idea of various forms of capital controls, temporary or otherwise, because they see – not just in the Asian crisis – that international financial markets can be severely dysfunctional. Wearing their 'businessman' hat, however, they want total freedom and national treatment. This suggests that a serious push for a more regulated international monetary system, complete with potential for capital controls, might not be as strongly opposed from Wall Street as is generally thought.

<sup>44</sup> The record-breaking rise in American stocks has been propelled partly by capital coming out of Asia. See Jonathan Fuerbringer, 'Markets are bolstered as investors flee rout in Asia', *New York Times*, 14 May 1998.

<sup>45</sup> Jacob Weisberg, 'Keeping the boom from busting', *The New York Times Magazine*, 19 July 1998, p.24 ff. Also Wade and Veneroso, *op.cit.*; Wade, 'The Asian debt-and-development crisis'. Note that the State Department, Commerce Department, National Economic Council, National Security Council and CIA have had virtually no role; Treasury has called all the shots.

<sup>46</sup> At the Hong Kong Annual Meeting of the Fund and the World Bank in late September/early October 1997 Eisuke Sakakibara, Japanese vice-minister of finance for international affairs, called a meeting of senior Asian finance officials without informing the Americans. When word reached Treasury Under Secretary Summers, he left his meeting, entered the room where the Asian officials were gathered, sat down at the table and said, 'Now where were we?'. From a source who requests anonymity.

well-working markets producing massive economic, political and social failures (as in 'The operation was a success but the patient died')?

The capital inflows were a function of capital account opening, fixed exchange rates, bank supervision inadequate for an internationalised system, depreciation of domestic currencies against the yen (because linked to the falling dollar), and higher returns to financial assets in Asia than in the US and Europe. The outflows were a function of capital account opening, appreciation of domestic currencies against the yen after spring 1995 (because linked to rising dollar), falling export growth and rising current account deficits, the combination of the last two giving rise to fears of devaluation.

The causation also has another strand relating to herding behaviour, information cascades and the like, that links individual rationality with collective non-rationality or suboptimality. What is striking about the Asia crisis is the abrupt shift of confidence from 'miracle Asia' to 'crony Asia' – a 'gestalt shift' in the language of cognitive psychology. In the famous drawing of a vase or a pair of intimated faces we see either one or the other, not some of one and some of the other, and the shift takes place instantaneously, not by degrees. This is a long way from the idea of rational, weighting-up risks and rewards calculation.

The notion of gestalt shift lends support to the 'panic' story – that the crisis was caused in large part by speculator and investor pullout from economies that, but for the pullout, would have remained viable enough to generate returns within the normal range. The panic, in other words, was not simply the 'trigger' or messenger of a crisis. The panic was a primary cause. The change in behaviour was much bigger than the changes in 'real' factors could warrant.

This line of argument suggests that had the massive outflow not occurred in Thailand, or had it been reversed in a matter of a couple of months, the Asia crisis would not have happened. One can see several turning points where things might have gone differently. The inflows would have been less large

had the countries not opened up the capital account earlier in the 1990s. The Japanese economy might still have been expanding had the Japanese government not made the colossal macro error in the spring of 1997 of raising taxes as the economy was slowing. Had the Japanese government in August 1997 matched its pledge to play a big role in promoting financial stability in the region with a contribution to the Thai bail-out of \$10 billion rather than \$4 billion, confidence might have been restored. Ditto had the US Treasury not shot down Japan's Asia Fund proposal of August 1997. Ditto had the US Congress not declined to provide more funds to the IMF in November 1997 because of a dispute about an *abortion*-related amendment to the country's foreign aid programme. It took an unlikely conjuncture of these and several other events that might easily have been different to produce a crisis on anything like this scale. In this sense the crisis was under-determined. This is to make the contrast with interpretations that stress major vulnerabilities in the real economy as the causes, according to which the crisis was over-determined – a major crisis was bound to happen and any of many events could have triggered it. The real economy trends, notably falling export growth and widening current account deficits, were amplifiers, not prime causes.<sup>47</sup>

China stands as a case in point. It has many characteristics of the crisis countries, pre-crisis, only more so: great dynamism and huge structural problems. Its banking system is in worse shape than Thailand's or Korea's before the crisis. Its escape from a direct hit reflects its closed capital account, implicit government guarantee of deposits, and big foreign exchange reserves. This same line of argument throws doubt on the popular moral hazard argument for why the inflows were so big. The moral hazard argument says that lenders lent appreciably more than otherwise because they believed they would be covered by implicit government or IMF guarantees. But the hypothesis is advanced without evidence that, for example, lenders lent more to companies, banks, sectors and countries where there was a stronger *ex ante* presumption of bail-out. It is equally plausible that lenders were paying no attention to downside risks, being carried along

<sup>47</sup> The analytical challenge is to marry the contingent nature of the Asian crisis with the propensity of the

world economy to generate credit balloons and crashes that rotate from place to place.

by the gestalt of miracle Asia and the incentives for herd behaviour. (Life insurance policies are not normally blamed for suicides.)

Much the same point applies to the popular 'lack of transparency' hypothesis about the size of the *inflows*: that lenders lent more than they would have had they been better informed about balance sheets, foreign exchange reserves and foreign debts. In fact, plenty of relevant information was publicly available; for example, the Bank for International Settlements' commentaries from early 1995 onwards stressed the build up of short-term foreign debt.<sup>48</sup> But investors were not reading – until after the crisis hit, at which point they refocused from macro indicators towards the micro indicators of debt maturity structures and the like that they could have been tracking all the while, had they a mind to. On the other hand, lack of transparency may have a significant role in explaining the magnitude of the panic, and hence the size of the *outflows*, for the reason given earlier.

The IMF argues that its far-reaching conditions for austerity and institutional reform boosted confidence as investors saw the governments taking firm action to repair the underlying vulnerabilities. The gestalt shift argument says, in contrast, that the news that a country was negotiating conditionalities with the IMF aggravated the loss of confidence, prompting a bigger rush for the exits; as did the signal that far-reaching institutional reforms were essential for growth to be restored.

The latter argument raises an interesting question of causality. IMF critics have pointed out that no sizeable *changes* occurred in indicators of national institutional strength in the last year or two before the crisis, and go on to ask how, given this, institutional factors could be assigned a large role. (For example, the ratio of short-term to total debt had been constant since 1993, and not so much above the rising Latin American average.) But weaknesses such as lack of bankruptcy codes and creditor rights may exist for years without causing difficulties, provided growth remains high. Once growth falters these same *constant* weaknesses may help to bring

on a crisis and hinder the resumption of growth. The question remains, however, whether the Fund should have insisted on such reforms in the middle of a liquidity crisis.

However the explanation is parsed, capital account opening is central. It exposed domestic financial structures – that had been strong enough to allocate huge domestic savings to generally productive and profitable investments over many years – to unbearable strain.<sup>49</sup> Yet the IMF and the US and UK Treasuries now insist that the crisis demonstrates the importance of liberalising the capital account even more – though in an 'orderly' way. Orderly means with a proper regulatory and supervisory regime in place. The way to create that regime, they say, is to bring in foreign banks and financial services firms to operate in the domestic market. They will demand an effective regime and help to supply the skills with which to operate it. In return, they will require freedom to enter and exit as they wish, and national treatment (parity with domestic firms, or better).

Even with a sizeable sector of foreign financial firms, developing an effective regime will take many years. And duration aside, regulation according to whose norms? The norms of a capital-market-based Anglo-American system are very different to those of a bank-based Asian system. The latter reflect the functioning of a system that allows firms to carry much higher levels of debt than consistent with Anglo-American prudential limits. The system has powerful developmental advantages as well as higher risks of financial instability. And it also seems to be a response to very high levels of household savings that are deposited in banks. A regulatory regime based on Anglo-American norms of prudent debt/equity ratios will probably not work in these conditions.

The idea that the way to avoid more Asian-style crises is to integrate national economies even more fully into world capital markets is implausible. As Dani Rodrik remarks, 'Thailand and Indonesia would have been far better off restricting borrowing from abroad instead of encouraging it. Korea might

<sup>48</sup> 'The Maturity, Sectoral and Nationality Distribution of International Bank Lending, First Half 1995', January 1996, Basle, p.5; and *66th Annual Report*, 10 June 1996, Basle, p.141.

<sup>49</sup> See *Governing the Market*, p.367, for the stability conditions of the bank-based high debt model.



just have avoided a run on its reserves if controls on short-term borrowing had kept its short-term exposure to foreign banks, say, at 30 per cent rather than 70 per cent of its liabilities. On the other hand, which of the recent blowups in international financial markets could the absence of capital controls conceivably have prevented?<sup>50</sup> There is little empirical evidence that capital account opening improves economic performance.<sup>51</sup>

The greatest concern about capital account convertibility, however, is that it brings economic policy in developing countries even more under the influence of international capital markets – the influence of a small number of country analysts and fund managers in New York, London, Frankfurt, and Tokyo. Even if it were the case that free capital movements do lead to efficiency *in the allocation of capital* and as such do maximise the returns to capital world wide, governments have much more than the interests of the owners of capital in view – or ought to have. They want to maximise the returns to labor, to entrepreneurship, to technical progress, and to maximise them within their own territory rather than somewhere else; they want to provide public goods that contribute to the good life. Only blind faith in the virtues of capital markets could

lead one to think that maximising the returns to capital and promoting development goals generally coincide.<sup>52</sup>

The crisis shows that the IMF must be redesigned. It demonstrated an overriding commitment to two goals – to protect the virtue of free capital markets by pinning the blame on ‘homegrown’ causes, and to ensure the repayment of the creditors. The actions it took in pursuance of these goals almost certainly made the crisis worse. It needs a constitutional change to give the interests of borrowers more weight.

Finally, we should insist on a linguistic convention. ‘Investor’ should be used only for someone who allows his money to be used for the production of goods and services in return for a share in the proceeds, including the purchase of new shares. Someone who buys financial assets in secondary markets in the expectation of subsequently selling them at a profit, due to exchange rate shifts or asset price shifts related not to dividend flows but to the number of buyers and sellers, is properly called a ‘speculator’. The distinction helps to avoid assuming that what is good for speculation is also good for investment.

<sup>50</sup> Dani Rodrik, ‘Who needs capital account convertibility?’, paper to be included in a publication of the International Finance Section, Princeton University, Harvard University, February 1998. Also Jagdish Bhagwati, ‘The capital myth: the difference between trade in widgets and dollars’, *Foreign Affairs*, May 1998.

<sup>51</sup> See Stiglitz, op.cit., Rodrik, op.cit., Bhagwati, op.cit. For evidence favourable to capital account opening, see Dennis Quinn, ‘The correlates of international financial deregulation’, *American Political Science Review*, Vol. 91, September 1997, pp.531–51.

<sup>52</sup> A point made by Rodrik, op.cit.